ECB policy change as part of political union

'Zero spread' idea plan needs integration commitment

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Many European leaders, past and present, have called for Europe to be a single entity – at least as far as the members of economic and monetary union are concerned – to replace the current mosaic of states, each one focused on national interests. German chancellor Helmut Kohl proclaimed on the eve of the Maastricht Treaty in 1991 that a monetary union without a political union would be a 'castle in the air'.

An optimal currency area cannot survive too long with strong divergence in bond market spreads. Monetary unions work in the long term only with a unique interest term structure. Financial spreads erode the competitiveness of affected countries, worsen disparities in trade and financial flows, exacerbate structural imbalances and contribute to political and social disaffection.

In the present circumstances we need a temporary, partial substitute for a not-yet-present, pan-European federal debt structure and a single yield curve. Our proposal (OMFIF commentary of 14 August) that the European Central Bank should commit itself to zero yield differentials on government bonds must be viewed in this context: of a Europe that is gradually maturing towards integrated political union.

At present, Europe's monetary constitution prohibits monetary financing of state deficits. Our suggestion of ECB purchases of member countries' debt, aimed at reducing spreads to zero, would sacrifice this principle to the greater good of creating a more sustainable Europe. This is a controversial proposition. To some, abandoning this state of affairs, with the ECB effectively guaranteeing member states' debt, seems a dangerous last resort that, by shielding them from financial market pressures, could lead governments towards fiscal irresponsibility. But this step can also be purely pragmatic: to extend temporarily the ECB's intervention capabilities in managing an incomplete monetary union, as part of a process of transforming it into something better.

Such a shift in monetary policy has to be conditional on governments proclaiming their intention to proceed to political union – a commitment that is often mentioned in European policy statements, but remains unsubstantiated and ill-defined. Much more is needed here. Any change in ECB policies must be firmly anchored as part of a definite, credible and implementable goal of full-scale political union.

Yet, beyond these longer-term considerations, the ECB has sound economic reasons to consider such an initiative. As an essential part of its mandate, it still has to counter the danger of deflation, despite the quantitative easing programme which began in March. Extended bond purchases, geared to achieving and maintaining a 2% inflation rate uniformly throughout the euro area, would have a part to play here.

The present bond market spread – 1.2, 1.4 and 1.8 percentage points respectively for the Italian, Spanish and Portuguese rate differential compared with Germany – partly reflects the different conditions of member countries' public finances when the financial crisis broke in 2007–08. Up to then, bond market traders around the globe, through their well-known convergence trades, brought about uniqueness of the interest rate structure.

Since then the spread has become a constant factor in sovereign debt markets. In a self-fuelling development, differences in member countries' perceived credit risk have become permanent.

Multiple sovereign yield curves benefit countries with low or zero spreads and penalise those with high ones. If country A's cost of servicing debt is reduced, it can allocate at least part of the savings in interest payments to public spending or to reducing the total amount of debt. Country B, facing higher debt servicing costs, will be required to do the opposite, reducing public spending (thus reducing growth) or increasing its debt – which, all other things being equal, will heighten the perceived risk of country B's debt.

Austerity policies in peripheral countries have dealt a heavy blow to domestic demand and sparked dangerous disinflationary (if not even deflationary) trends. On the other hand, countries with low interest rates gain self-evident advantages. Germany's habitual large trade surplus since the beginning of the euro owes much to German industry absorbing demand from the euro periphery. According to European rules, this kind of high and persistent trade balance is an anomaly deserving of sanctions. But so far Germany has received no more than harmless warnings.

Unfortunately, the euro area lacks automatic stabilisers to counteract a self-perpetuating yield spread. There is no federal budget and no mutualised federal debt. For this reason our proposal focuses on a new role for the ECB, since this is the European institution in the most advanced stage of development.

Unless Europe introduces a more intelligent economic, fiscal and monetary policy, Europe's catch-up process will never happen. We can keep the economic ropes tight to avoid 'free riding' and drive forward reforms, but we cannot use the ropes to strangle weaker countries. Ultimately the euro area needs a significant federal tax authority, a federal budget and a federal debt.

Action by the ECB to guarantee member states' debt is not a long-term solution. Rather, it provides a useful means to push the politicians to move to the final destination of European integration: full-scale political union.

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